



## CONSULTING ASSISTANCE ON ECONOMIC REFORM II

# DISCUSSION PAPERS

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### **Promoting Export-Oriented Foreign Direct Investment in Developing Countries: Tax and Customs Issues**

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**Promoting Export-Oriented Foreign Direct Investment  
In Developing Countries: Tax and Customs Issues**

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## **Promoting Export-Oriented Foreign Direct Investment In Developing Countries: Tax and Customs Issues**

### **I. Introduction**

There has been a growing emphasis in many developing countries to adopt an export-led growth policy that attempts to attract both domestic and foreign investment into activities that will increase exports. Many countries, however, have not achieved the desired response. Among other problems, investors often face foreign exchange controls, tariffs on imported inputs, and a costly system for the exemption or refund of sales taxes on inputs used to produce exports. These factors have frequently impeded the inflow of foreign investment and prevented the expansion of export production and sales.<sup>1</sup> This paper addresses two issues related to the design and administration of some of the fiscal provisions that affect the competitiveness of a country in the production of non-traditional exports.

The first issue is how to design a system that allows exporters to sell their output free of domestic sales and excise taxes. The value-added tax (VAT) is the most common form of general sales tax, having been implemented in more than 120 countries.<sup>2</sup> Under this system, in order for exports to be sold free of tax, they are generally taxed at a zero rate and the exporters are allowed to claim as a refund any tax paid on input purchases. The refund procedures of many VAT systems, however, do not function well. Refunds are either not paid in a timely fashion by the government or are overstated by exporters. The procedure seldom works, as it should.

The second issue is how to relieve exporters from the burden of taxes levied on imported inputs used in the production of exports. These taxes can be very serious especially if import tariff rates are high. The mechanisms to remove this export impediment include tax free zones, duty draw back systems, duty exemption systems, bonded warehouses, and duty free factory systems. All these systems have some limitations and are not equally effective in achieving their intended objectives.

In this paper, we report how several countries in three continents, Africa, Asia and Latin America, have addressed these issues. These countries include Ghana, Kenya, Malawi, and South Africa in Africa; Indonesia, Korea, Malaysia, Sri Lanka, India, Pakistan, Taiwan and Thailand in Asia; and Argentina, Chile, Dominican Republic, Mexico and Uruguay in Latin America.

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<sup>1</sup> The effectiveness of the institutional arrangements to promote exports is equally important for success in investment and economic growth. See Dani Rodrick, The New Global Economy and Developing Countries: Making Openness Work, published by the Overseas Development Council, Washington, D.C. (1999).

<sup>2</sup> The situation in India is worse. In India, with its central excise tax system and its state level sales taxes, a situation is created where it is virtually impossible to determine the amount of sales and excise taxes embodied in the cost of producing exports. See Thomas Maxwell, "Making India a World Class Exporter", published by the World Bank, Washington, D.C. (1999), p. 6.

Our objective is to identify the primary elements of the administrative systems needed to deliver the VAT input tax credit refunds effectively and to eliminate the burden of duties on imported inputs used to produce exports. From the fieldwork, we have discovered why some systems work effectively in some countries, while in others, they do not seem to work. The paper should help policymakers in developing countries to evaluate the different policies and administrative systems frequently used to address these issues.

## **II. Tax Relief for Exporters under VAT**

### **2.1 Basic Input Tax Credit System**

Under the credit invoice method, all VAT registrants are obliged to collect and remit VAT on their taxable supplies. These registrants are allowed to recover the tax paid on their purchases. For each reporting period, registrants have to calculate the tax collected and remit to the tax authority the amount that is in excess of the taxes they paid during that period on their purchases of inputs. If the difference is negative, however, registrants can claim the difference as a tax refund. This is theoretically how the operation of a VAT system of the invoice and tax credit method of administration is supposed to operate.

In certain situations, a registered vendor may be involved in supplying both taxable and tax-exempt goods and services. In this case, the input tax credits are allowed only to the extent that the business inputs are used in the taxable supply of the vendor. In other words, when a vendor is involved in both taxable and exempt supplies, the credit is only available to the extent that the purchased inputs are considered reasonable for use in the taxable supply. As a result, apportionment rules for the input tax credits are required to allocate the tax credits between the different supplies of a business operation. If the exporter is also engaged in exempt supplies, an apportionment in input tax credit must be applied to ensure that no excess input tax credits are granted for the exempt business.

In brief, the tax structure under the VAT system completely removes taxes from exported goods and thereby makes the exports more competitive in international markets. The system clearly encourages investment and fully supports exports.

### **2.2 Tax Refunds to Exporters**

To facilitate a smooth operation and to protect the government revenue, registrants are required to maintain records to substantiate their entitlements for the taxes paid on purchases used in the production of taxable supply. In other words, registrants must provide to the tax authority a satisfactory invoice or other document reporting tax paid on business inputs.

Additionally, since imports are normally payable at the time of importation, the VAT paid on imports is, in fact, included as part of the registrant's input tax credit entitlement. In most countries, the proportion of VAT collected at Customs is generally very high. For example, the ratio is about 50 percent in Mexico, 40 percent in Indonesia, and more than 100 percent in Czech Republic. Since exports are generally zero-rated, exporters can

claim the taxes paid on their inputs as a refund. As a consequence, exporters tend to be in the chronically difficult position of waiting for a refund on excess tax credits.

Most VAT jurisdictions allow taxpayers to choose to file tax returns more frequently than the legal requirement. For example, a business can opt to file monthly, even if it is legally allowed to file its tax returns in a longer reporting period, such as quarterly. Because exporters are claiming refunds rather than paying tax, they have an incentive to file their tax returns more frequently in order to get their refunds earlier. This makes the administrative problem worse because of the volume of transactions this practice creates. In order to reduce this problem, some countries, such as Taiwan, do not levy VAT on goods at the time of importation.<sup>3</sup> The tax is automatically deferred until the goods using the imports for production are sold. Authorities will reduce the tax refund from the purchase of inputs for exporters who owe no VAT tax on their sales.

To ensure that goods are, in fact, exported to qualify as a zero-rated supply, exporters must ship goods outside of the country and obtain a receipt for the payment of the sale. This is important since some countries, such as Korea and Thailand, experienced a heavy volume of fraudulent invoices immediately after introducing their VAT systems.

The other question is how long the government takes to refund the excess tax credits to taxpayers. This is critical to exporters, since they must tie up substantial amounts of cash by paying input taxes. Obviously, they would like to receive a refund as quickly as possible to restore their cash flow. In several of the countries studied, it was not uncommon for exporters to wait for up to one year to obtain a refund for the taxes paid on inputs. An extreme case is found in the development and exploration of mining activities, where the large costs and input tax payments are incurred years before these mines become operational and their output is able to be sold in the markets.<sup>4</sup> Often, no refunds are actually paid to the “potential” exporter until the mine is in operation.

## **2.3 Issues and Potential Solutions**

A VAT system can not operate effectively in the absence of a well-functioning input tax credit and refund system. In the case of suppliers to the domestic market, most countries specify that the input credits are to be used immediately to offset taxes due on sales; or if there is an excess of credits, that they are to be carried forward to offset taxes due in the future. If the tax credits continue to be in excess of taxes owed for a specified period of time, then usually a provision is available to refund the excess tax credits in cash. For businesses selling to the domestic market, the need for cash refunds of excess credits is a relatively infrequent event. The situation is very different in the case of major exporters. For example, in Uruguay, which exports very few manufactured items, the refunds given to exporters accounted for over 80 percent of all refunds. Here the excess credits will exist from before start-up and will accumulate. In order to prevent placing the exporters at a

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<sup>3</sup> In the case of goods imported by individuals or non-registrants, the VAT is collected at the Customs in Taiwan.

<sup>4</sup> This issue was raised by tax practitioners for Canadian mining companies that were involved in several mining projects in Latin America. They objected to the problems such a situation created with cash flow.

competitive disadvantage internationally, they need a mechanism to turn the tax credits from input purchases into cash.

At the same time, the refund system for exporters is one of the primary areas where major fraud can and does occur. For example, exporters may take undue advantage of their refund position and apply for excessive refunds on the basis of fake invoices for input purchases. This has been a major problem in the administration of the VAT system in Thailand. Cases of such fraud have been reported in Uruguay, Mexico, and Indonesia. Another example of such fraud is when businesses export goods and receive a refund for input taxes, but then smuggle the goods back into the country to be sold in the domestic market without paying import duties and taxes. The administrative issues become even more complicated and fraud is made easier in the regional duty-free trading zones, such as the Common Market for Eastern and Southern Africa.<sup>5</sup>

Most of the exporters would like to get their refunds quickly from the government in order to reduce their net cash outflows and thereby lower their cost of doing business. The government may also have a policy to help businesses by speeding up the payment of refunds. In such a situation, the tax administrators find themselves facing a dilemma. Will they process the refunds quickly and face the risk of approving fraudulent claims? Or will they audit every claim and, as a result, delay the payment of refunds to everyone? In many developing countries, the result is the worst of all possible scenarios: because of the delays, the honest exporters have to bribe or “tip” the tax officials to get payment of their legitimate refunds. At the same time, such corruption makes it possible for businesses to bribe the tax administration officials to process fraudulent claims as well. Because of this potentially lucrative situation for auditors, a substantial number of them are assigned and/or are attracted to managing the export refund system. The end result is that the tax administrators make substantially more than they otherwise would receive as wages and salaries from the tax department, they pay more fraudulent refund claims, and the legitimate exporters get far less than they are entitled to. The economy, through the loss public sector revenue and reduced earnings of the legitimate exporters, bears the cost of this process.

From our international study of the VAT tax credit refund systems in developing countries, we have identified one “innovation” that appears never to work and three that show considerable promise

The innovation that shows little or no promise is creating a new agency separate from the VAT and customs administrations, such as an export promotion agency, to administer refunds. Massive fraud is the usual result. The Philippines is currently experiencing such fraud; and Indonesia experienced similar difficulties in the early 1990s. These agencies never have the necessary information or technical skills to determine whether a claim is legitimate or fraudulent. Furthermore, such agencies do not have the safeguarding of the

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<sup>5</sup> See Graham Glenday, “Customs and Trade Facilitation: Challenges and Opportunities in Sub-Saharan Africa”, paper prepared for the Symposium on “Innovations in Trade Administration: Customs in the 21<sup>st</sup> Century” held by the Harvard Institute for International Development and the International Tax Program, (November 14-15, 1996).

integrity of the fiscal system as their mandate; they exist solely to promote exports. Almost always, the government eventually terminates such separate administrations after a major fraud is exposed.

In contrast, our studies revealed an innovation that has demonstrated some success in speeding up the payment of refunds, but does not entirely alleviate the cash flow cost. With this scheme, the government requires taxpayers who apply for tax refunds to place bonds or a deposit equal to the amount of the refund (or some percentage of it) in special bank accounts until the government is comfortable with the claim. This scheme can apply to exporters as well as local firms requesting tax refunds. Firms that have developed a proven track record of honesty might be allowed to maintain a bank guarantee for a smaller percentage of the outstanding claims. This scheme places a tighter degree of control on excess input tax credits under the VAT system. Such a system was implemented in Taiwan during the early years of export expansion with great success. The government of Mexico has been implementing a similar but not so tightly structured scheme since 1999.

According to this system, the tax authority should approve or deny the refund within a prescribed time period. If the government does not meet its deadline, the taxpayers should be entitled to receiving interest on the amount of the refund.

The second scheme is to have tax refunds claims certified by chartered accounting firms or certified public accountants. This allows taxpayers to use the recognized accountant firms to verify the financial statement and claims for input tax credit, thereby placing the responsibility of tax liability on both the taxpayers and accountants. This option should eliminate most of the fraudulent claims and, hence, reduce the government's administrative costs. After Kenya introduced this system, the number of export tax credit refunds for VAT dropped by over 40 percent. Clearly, many firms had been submitting refund claims for VAT that did not stand up to the scrutiny of financial auditors. Such a system also frees foreign-owned firms from dealing with local tax officers,<sup>6</sup> thereby reducing their compliance costs. Although the local accounting firms charge for their services, the service charge is well worth the cost since they are usually better equipped to deal with the local tax administration.

To be cost effective, one should have place a threshold on tax refunds for those who are eligible for immediate refunds with signature of certified accountants or chartered accounting firms. The threshold will effectively cut down the government administrative costs.

The third alternative for speeding up payment of refunds is not to impose VAT on business purchases at the time of importation. By not charging VAT on imports, importers are not entitled to input tax credits when the imports are used in the production and distribution process. Hence, making imported inputs for export production VAT-

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<sup>6</sup> For example, some foreign firms in China have experienced a great deal of difficulties in getting input tax credits. These firms often have to deal with local authorities that have different interpretations of the tax laws.



exempt, or taxed at a lower rate at the time of importation, can substantially reduce the VAT input tax credits and claims for refunds by exporters. This approach has been implemented in Taiwan and Singapore. In Mexico, the government taxes import transactions at a lower rate when they are destined for the export processing zones along the Mexico-USA border. This essentially pursues the same objective.

This option, however, may also create problems. If the importers cease operation or no longer file tax returns after bringing a consignment of goods into the country, then the government never collects, resulting in a revenue loss. In other words, the importers bring the goods into the country tax exempt and then attempt to sell the goods domestically without paying the VAT taxes. This can be significant in less developed countries where the informal sector of the economy is relatively large. It may also increase the administration costs for the government by breaking the invoice-tax-credit chain in the production and distribution process under the VAT. Depending on the country in question, this option may reduce the disruption to export businesses due to the administrative inadequacy of the VAT tax refunds system.

To reduce the incentive for fraud and to increase the compliance in the tax withholding system for the income and social security tax systems, a country might wish to issue tax credit certificates to the exporting firms instead of cash payments to cover the VAT refunds. This system has been implemented in Uruguay with considerable success, although some fraud still has taken place. Virtually all firms will have withholding tax obligations that are substantial in the area of payroll and social security taxes. It is likely that the VAT tax credits that need to be refunded to exporters will be less than those withholding obligations that these same firms should be paying. Hence, by integrating the administration of the refund system for VAT with the withholding tax system for wages and salaries, both systems might be strengthened.

Nothing in tax administration is automatic. The auditing of the tax credit certificates to determine if they are legitimate is essential. However, at least the completely fraudulent exporter is likely to be restrained, because the tax credit certificate has value only if the firm also has employees and wage withholding obligations. These certificates should not be tradable (at least initially) between enterprises. There may be a few exceptional cases where the firm's withholding obligations are less than its excess VAT input tax credits. Provisions might be necessary to issue cash refunds in these cases; however, the number of such cases will be very few as compared to the total that would exist if the tax credit certificate system were not employed.

These proposed institutional changes to the normal VAT administration can help to increase the effectiveness of the VAT systems, but they do not comprise a complete solution. The auditing function of the tax administration needs to be built and maintained. When this component of the tax administration is weak, then substantial fraud is likely to follow. Uruguay, which has a fairly good VAT tax administration, has approximately 50,000 VAT taxpayers and 70 full time auditors. By comparison, Sri Lanka, which has 15,000 VAT taxpayers, has only 12 auditors. Sri Lanka is trying to operate with about 60 percent of the auditing strength as is found in Uruguay. Hence, we should not be

surprised when we find that Sri Lanka experiences both delays and other problems in its VAT refund system.

### **III. Relief of Trade Taxes for Exporters**

#### **3.1 Conceptual Framework**

The expansion of manufacturing exports has been shown as one of the most important vehicles for economic growth in less developed countries. To be successful in international markets, exported goods must be competitive in terms of both quality and price. In order to achieve this objective, governments should pursue a general public policy to ensure that their exported goods and services are free of indirect domestic and trade taxes. As discussed above, all exports are zero-rated under the consumption type VAT. As such, the government credits taxes paid on business purchases. In this manner, all exported goods or services are sold completely free of domestic indirect taxes.

To get the same result for trade taxes, the government should either exempt or refund the import duties imposed on business inputs. This would, in effect, remove the tax burden that is embodied in the cost of inputs used to produce exports. For this to happen, the government needs to remove import duties not only from goods directly imported and used in the production of exported goods, but also from the cost of local goods that, in turn, use imported inputs in their production.<sup>7</sup> The government should credit or refund the import duties embodied in the cost of the domestic inputs in order not to penalize exports that use such goods.<sup>8</sup> Unfortunately, in order to refund these hidden taxes, the administration must perform a series of calculations that involve tracing through the backward linkages of the production process, and would be administratively complex to estimate.

In theory, imported machinery and equipment, if they are to be used in the production of exports, should also enter the country duty free in the same manner as raw materials. Since capital goods are often used to produce both taxable (including exported and domestically taxable goods) and exempt products, the government may find it once again administratively cumbersome to tease the two apart in order to estimate the correct amount of rebate. In addition, manufacturers use capital goods over a long period of time and it is very difficult to forecast whether firms will continue using the capital items to produce for export into the future. Again the complexity of calculating the portion of import duties levied on capital goods used only in the production of exports is likely to be extremely cumbersome.

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<sup>7</sup> See, e.g., Thomas Maxwell, "Modernizing Pakistan's Export Policies", paper prepared for the World Bank, (July 1998); Graham Glenday and David Ndii, "Export Platforms in Kenya", paper prepared for the Harvard Institute for International Development, (July 21, 1999).

<sup>8</sup> As demonstrated by Maxwell, there always exists some kind of hidden tax on exports so long as there are duties imposed on imported goods for the purpose of protection. See Thomas Maxwell, "Modernizing Pakistan's Export Policies", paper prepared for the World Bank, (July 1998).

### 3.2 Alternative Schemes and Operations

The objective of the policy is to provide relief from import duties on inputs only to those firms producing goods (and sometimes services) that are being sold abroad. It is also very common for some firms to simultaneously produce goods for sale in the domestic market. The government should tax this type of firm on the imported inputs used to produce the goods sold domestically in the same manner as they tax imported inputs used by firms producing solely for the domestic market. Otherwise, an unequal treatment will occur.

Several alternative approaches have been undertaken to deal with this issue of relieving import duties. They include duty drawback and duty exemption (or suspension) for import duties, and are described below. In the viewpoint of a physical description, they can be classified into bonded warehouses, export-processing zones, bonded factories, and science-based industrial parks. Details of these schemes implemented by countries are presented in Table 1

#### 3.2.1 *Duty Drawback System*

The duty drawback system is the classical and the most common method of relieving import duties imposed on goods used for the production of exports. In general, firms must meet several conditions before the government can refund duties. First, the firms had to have paid the import duty in cash. Second, the firms had to have exported the final products. Third, the amount of duty drawback is based on the amount of duty paid on imported inputs used in the total production of the exports destined for the foreign markets.

The imported goods eligible for duty-free are raw materials for all countries that have the duty drawback program. However, the goods may be extended to include fuel, packaging materials, machinery and equipment, depending upon countries and even stages of their economic development.

Virtually all countries that provide incentives to export-oriented firms have the duty drawback system. Because the duties are paid upon importation, refunds may be claimed by importers, exporters, or manufacturers of exported goods. Manufacturers of exporters are the kind of indirect exporters and a question arises as to the number of prior stages that should be allowed.<sup>9</sup> Korea, Taiwan, Mexico and Kenya are examples of countries that have allowed indirect exporters to claim duty-exempt imports. The most difficult issue becomes to what extent import duties should be refunded to indirect exporters. In the case of Taiwan, a sophisticated input-output coefficient was developed and calculated for each line of production. This ensured the precise amount of hidden tax in the exported goods but it was undoubtedly cumbersome and the government had to employ a great number of personnel to deal with this program. In the other extreme, Kenya adopted a single fixed coefficient for all goods for the sake of simplicity. But inequities among goods became obvious and it was eventually forced to change its system.

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<sup>9</sup> In the case of Kenya, the back linkage may go back two stages of production.

Corruption is a universal theme surrounding the administration of a duty drawback system in practically every country. The nature of the problem that a duty drawback is supposed to address and the administrative procedures it entails incubates corruption. There are several reasons for this. First, when the goods are first imported, there is no information recorded that these items will be used to produce exports. Hence, in most countries, Customs will not be able to trace the actual import entry of the items that are embodied in the exports. Generally, they will have to rely on customs documents that the exporter provides.<sup>10</sup> Here there is an opportunity for the exporter, perhaps with the collusion of some customs officers, to exaggerate the amount of duties actually paid on the imports.

Second, only the exporters know the quantities of materials used in the production processes. Due to differences in models, sizes, and quality of the items being produced, the duty drawback administration will have to either take the exporters' values for the inputs used, negotiate the quantities, or specify arbitrary (and usually inaccurate) input-output coefficients for each item produced. These input-output coefficients are finally settled in the negotiations between the producers and customs officials.

In the industrialized countries, the solution to the above two problems is to have a system of professional audits of the books and records of the exporting firm, combined with sound technical information on the manufacturing processes. Unfortunately, the recommendation usually made by advisors from advanced industrialized countries of detailed auditing by the duty drawback administration is largely irrelevant. Developing countries do not have the available professional auditors, nor is the government usually able to pay competitive wages. Even if they could obtain professional auditors, they would most likely be needed in areas of greater priority. When one finds professional auditors working in the duty drawback area, it is often because they are attracted to the area by the amount of facilitation payments they expect to receive.

The third reason for the failure in implementation of duty drawback systems is because there is a great reluctance on the part of Customs to return the duties paid. The revenue administrators, and especially Customs, have no incentive to refund duties in a timely fashion, since refunding this money makes it harder for them to meet their revenue targets. As a consequence, many governments do not treat duty drawbacks as a reduction in revenue, but as an explicit expenditure item in the budget. Unfortunately, this procedure puts the duty drawback refunds under the same constraints and uncertainties as all other discretionary budgetary expenditures.

Due to the likely disputes over the amounts of drawback refunds that are to be properly refunded, the risk of error that might prove embarrassing to the administration, as well as this organizational disincentive to pay the refunds in the first place, the usual reaction is to delay payments. In order to overcome the reluctance of the bureaucracy to actually make the refunds, exporters make facilitation payments to the duty drawback administrators in

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<sup>10</sup> When the duty drawback system involves parties such as importers, exporters and manufacturers of exporters, the applicant for tax refunds in Taiwan has to obtain a letter of consent from the other parties who are involved and do not file for refunds. This makes the system even more cumbersome administratively but no double refunds would take place.

practically every developing country in the world. Once exporters make these facilitation payments in order to obtain payment, then a general market is usually created to determine all aspects of the duty drawback refund, from the amount of inputs used, the amount of tariffs paid on the imported input, and the amount of goods actually exported.

Sooner or later, as the compliance costs mount, it becomes obvious that the duty drawback system is not an effective way to relieve exports from the duties paid on their imported inputs. As a consequence, other ways of providing duty relief are substituted for a duty drawback system. A common characteristic of these alternative methods is for exporter to make no payment to Customs when the inputs initially enter the country.

### ***3.2.2 Duty Exemption System***

In the duty exemption schemes, the government sets up an account-offset system so that import duties can be held in suspense as liability. The liability is then cancelled upon export. Because the liability is accounted for by the specific importer, the account-offset can only be claimed by the importer himself. Usually, an importer shall apply for a record of accounts with the Department of Customs. Upon the exportation of the finished products, the refundable amount is credited to the payer's account. Under the duty exemption scheme, imported goods can be released by Customs and no taxes need to be paid first and refunded later. The businesses maintain an accounting of the imports purchased and used, but Customs is made aware of the reason for the importation of the inputs at the time the goods enter the country. Customs will also have to maintain an account of what was imported and what duty is owed.

Both the duty drawback and the exemption systems operated concurrently in Taiwan, but the exemption scheme has been the instrument that has been more important since the 1970s.<sup>11</sup> This is also the case in Malawi where the duty drawback program did not work well because the government delayed refunding the import duties and surtax imposed on imported and domestically purchased inputs,<sup>12</sup> creating a cash flow problem. The incentives for investment and economic growth do not seem to be effective in Pakistan, even though both schemes are allowed for use.<sup>13</sup>

With the duty exemption system, the administration's problem of determining what has been imported and what duties have been suspended is usually solved by the normal entry procedures of customs. The abuse of the system comes when exporters have not exported the goods produced by the inputs and at the same time are not voluntarily prepared to pay the duties that were suspended. To prevent this form of tax abuse under the suspense system, the importer is normally required to supply the government with a guarantee. Common forms of such a guarantee are the purchase by the exporter of government bonds

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<sup>11</sup> Chun-Yan Kuo, "Tax Incentives in Taiwan", background paper prepared for Harvard Institute for international Development, (December 1998).

<sup>12</sup> Clive Gray, "The Effectiveness of Tax Measures to Promote Export Growth in Malawi", paper prepared under the Malawi Economic Management and Reform Project, funded by the United States Agency for International Development, (July 1999).

<sup>13</sup> The suspense scheme is hardly used in Pakistan where less than 5% of export transactions use this scheme.

or negotiable securities approved by the Ministry of Finance, or bank drafts issued by a financial institution in the amount equal to the duty payable. In this way, the government is assured of receiving the revenues that are owed, while at the same time the firm will receive an interest rate on the amount of funds it invests in government bonds. Alternatively, if the firm purchases a bank guarantee, it will incur the cost of the guarantee but it does not need to incur the cash outflow to purchase the financial asset. This was the system undertaken in Taiwan and became very popular especially to large businesses because of cash flow advantage to importers.<sup>14</sup>

In Mexico, the suspense or exemption system was adopted but it was widely abused because initially there was no requirement for bonds or bank guarantees. As a result, the government of Mexico introduced a system of Customs Bank Accounts in 1999. Under this new system, the direct and indirect exporters are required to deposit an amount of funds equal to the taxes under suspense in interest bearing accounts in banks. The Customs Authority will release the funds back to the firms upon approval of claim for duty remission on the inputs used to produce exports.

The exempt scheme was adopted in Korea in specific locations such as export processing zones and bonded warehouses or factories that are discussed later.

Corruption has been much less prevalent in duty exemption systems. This is due to the fact that it requires a record of the transaction, starting at the point when the imported inputs enter the country. When an accounting entry is made by both the firm as well as the customs system at the beginning of the process, without money having to change hands, what is being imported and for what purpose becomes much more transparent. Often the duty exemption is given only if the firm already has an export order for the items being produced. The interest bearing bank deposits or guarantees reduce the incentive for the private exporters to pay bribes to the administration officials. At the same time, the involvement of the banks that are often working with the businesses in much more important ways, such as the financing of firm's investments, reduces the incentives for the firm and the government officials to engage in corrupt practices. Simply put, the duty exemption system drastically reduces the power of the government officials over the resources of the firm, and also reduces the financial stakes for the firm and its incentive to pay facilitation payments.

### ***3.2.3 Export Processing Zones***

Use of export processing zones (EPZs) to promote export has been quite popular in many developing countries around the world. These include Taiwan, Dominican Republic, and Kenya. Some countries have been successful, but not all.

EPZs are a type of free trade zones established to process goods for exports exclusively. The zones are usually located in the vicinity of harbors or other forms of international transportation. They are surrounded by a physical wall to ensure that goods will be taxed

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<sup>14</sup> In late 1970s, the amount of tax relief using the suspense scheme accounted for approximately 80% in Taiwan. Details can be found in the case study of Taiwan.

when leaving the tax free zones areas for domestic markets. The administrative operations in this bonded area are theoretically simple, straightforward and all trade-related activities can be handled in the zones. As such, foreign investors do not have to deal with the domestic bureaucracy's specific regulations, rules, foreign exchange transactions, etc. and thus business transaction costs are greatly reduced.

With the EPZ, no import duties are levied on materials and other intermediate inputs, nor are equipment or parts and components used in the production within the EPZ. The EPZs in Taiwan and the Dominican Republic have been regarded as successful examples and they are important vehicles for facilitating exports. The share of total exports by Taiwan originating from the zones, however, reached a peak of only 9 percent in the 1970s. Thus other institutional arrangements to provide duty relief, such as Taiwan's accounts based duty exemption system has been much more important in the promotion of exports and economic growth.

It is also interesting to observe what has been happening in Kenya with respect to EPZs. Although they have been built at great expense they have been characterized by excess capacity.<sup>15</sup> The fundamentals of international trade such as the small size of the regional Common Market for Eastern and Southern Africa, inadequate infrastructure in Kenya, and appreciation of the domestic currency and rising labor costs, have kept international trade flows much smaller than anticipated.

In a situation where a country has very high tariffs, inadequate infrastructure for modern industries to function, and a full blown rent seeking bureaucracy, the use of EPZs may be the only way that reform minded policy makers can get an export oriented growth strategy started. However, the traditional public sector EPZs with their high fences and customs officials riding trucks going in and out of the premises are an idea whose time has largely passed. EPZs are expensive to build and usually only serve well the needs of footloose types of industry, such as garment and shoe manufacturing, and some forms of electronics. They also make it expensive for local manufactures to get into the exporting business if they have to relocate their export manufacturing activities to the EPZ in order to get themselves free of indirect taxes and a rent seeking bureaucracy. With the rapid fall in the cost of information technology and accounting systems, the bonded factory or warehouse that is not tied to a specific location seems to combine the best aspects of the EPZ and the duty exemption schemes.

#### **3.2.4 Bonded Factory or Warehouse**

Unlike the EPZs, the customs bonded factories or warehouses can be set up anywhere at the convenience of the producers. The functions are essentially similar to those of EPZs so that the bonded factory can reduce congestion in the EPZs and also offer some flexibility for firms to be close to resources used in their production. Unlike the EPZs, the bonded factory is usually allowed to get imported raw materials and intermediate inputs

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<sup>15</sup> A detailed discussion of the experience of Kenya is found in Graham Glenday and David Ndii, "Export Platforms in Kenya", EAGER/Trade Regimes Research Paper, Harvard Institute for International Development, (July 1999).

duty free. However, the government levies on equipment or parts used for maintenance of the factories. This is due to the dual function of such production facilities.

To reduce the level of fraud caused by the selling of duty free imported inputs out of the bonded warehouse, it is usually necessary for the firms to post some type of guarantee bond, or bank guarantee or government security. In some countries, the firms that have a clean track record are allowed to post only a promissory note with collateral.

Although the bonded factories were set up for exports, the products may also be sold to domestic customers. When this occurs, the factories in countries such as Taiwan are required to pay duty only on the imported materials used to make the goods sold domestically. This places the bonded factories on an equal footing with other domestic manufacturers. Because these firms are able to be competitive enough to export these items, the prices of goods sold on the domestic market will tend to get bid down to their fob prices, plus the tariffs paid on imported inputs.

Korea's and Kenya's system for equalizing the playing field is very different. Instead of disallowing tax exemption for imported materials, Korea and Kenya impose final goods tariff rates on any of the final products sold in their domestic market. This provides these firms with the same level of protection as a pure domestic supplier selling in the local market. As a consequence, the economic efficiency cost of domestic protection is much higher with the system used in Korea and Kenya as compared to the system used in Taiwan.

The bonded factory is a self-administered system. In order to function properly, each factory must have comprehensive accounts for materials, finished products and information on the amount of materials required to produce each finished product per unit. Imported materials taken out for the manufacturing process need be carefully monitored. The system would operate in such a way that detailed records of the quantity of imported materials is kept. When the firms export finished products, they reduce the corresponding imported materials used to produce the products in the account.

There is an automatic policing mechanism built into the bonded factory or warehousing system that reduces the incentive for firms to leak duty free imported inputs without paying taxes. If such sales should occur, they will be detected immediately by competing suppliers who have already paid import duties. These businesses will be put in peril very quickly by these illegal sales, therefore, it can be expected that they will complain immediately. The most common form of sanction against the operator of the bonded warehouse or factory is to have the license to operate such a facility revoked. This is a severe economic punishment, and one that the operator of the bonded warehouse facility is very reluctant to risk. Furthermore, if they are in the business of manufacturing for export and domestic sales, a sideline of smuggling is not particularly appealing when the probability is high that they will get caught by competitors whose silence is difficult to purchase. This policing system no doubt goes a long way toward explaining why, in countries such as Malawi and Ghana, very little fraud from the sale of duty free imports is



reported, despite the fact that these countries' controls over in-bond facilities are rather rudimentary.

The number of bonded factories is large in countries such as Malaysia, Taiwan, Mauritius, Korea, Kenya and Pakistan. They have been quite successful in promoting exports.

The concept of the bonded factory was extended to the science-based industrial parks in countries such as Taiwan in order to promote the development of science and technology in the island. The tax incentives provided to the parks are in fact the same as those in the EPZs but focus on computer, automation, and scientific research. The firms in the parks appear to have made a significant contribution to the recent economic growth in Taiwan, especially in electronics and other high-technology goods.

### **3.3 Institutional Arrangements**

Removing duties on imported inputs for use in the production of exports is very important for developing countries to compete their products in international markets. In fact, the duty remission -- either duty drawback or exemption -- has been shown to be the most important policy measure for the Taiwanese exporter in the 1970s and 1980s.<sup>16</sup> However, development of the mechanisms and institutional arrangements to implement this policy is equally essential for a successful export promotion and economic growth. Without proper institutions and an effective administration, the export promotion policy may not lead to economic growth.

The most common mechanism to eliminate duties from inputs is the duty drawback system. The administrative complexity of this mechanism is a major deterrent to its use. It can relieve import duties paid and embodied in the production of indirect exporters for small exporters or irregular exporters. It is a necessary but far from a sufficient mechanism to provide relief to exporters from the burden of import duties on inputs.

In administering either the exemption or suspense system, it is important for the government to develop computerized records of imported inputs and export sales. With this system, the proper accounts and records in terms of import duties payable and drawbacks claimed must be well maintained. In addition, the importer should be required to supply the government with government bonds or securities issued by a financial institution in the amount equal to the duty payable. The interest associated with these bonds or securities should be payable to importers. This would minimize the cash flow cost to importers as well as protect the tax revenues for the government. Customs should administer these activities as information from customs transactions is critical. The system implemented in the Philippines whereby a One Stop Shop authorizes and issues Tax Credit Certificates is not one to be emulated. It is extremely difficult to maintain transparency of what is or is not exported, and the implementation of such systems often results in major fraud.

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<sup>16</sup> See, Glenn P. Jenkins and Chun-Yan Kuo, "Which Policies are Important for Industrialization: The Case of Taiwan", International Tax Program and Harvard Institute for International Development Development Discussion Paper No. 594, (July 1997).

The EPZs may in theory appear to be conceptually ideal, but they have proven to be expensive and inappropriate for many industries, particularly those that already have a domestic operation. The bonded factories or warehouses can be located individually anywhere in the country, so long as records on import duties payable and credits claimed are well maintained for inspection by Customs personnel. The system has a fair amount of self-policing built into it but randomly targeted inspections by government officials will always be required.

#### **IV. Conclusions**

A clear conclusion of this analysis is that the administration of the indirect tax on the inputs used by exporters is a critical determinant of the ability of producers of a country to be internationally competitive. More can be said with certainty about what will not work than about what will be successful. We know that One Stop Shops for the refund of VAT credits that is divorced from the administration of the VAT and Customs is a prescription for massive fraud. The evidence is also overwhelming that traditional duty drawback systems are almost always the catalyst for corruption, and are costly and ineffective at relieving exporters from the duties they pay on imported inputs.

Creative administrative designs that rely on markets such as bonds, bank guarantees, or accountant's professional reputation, have been used effectively in selected countries. There is no single prescription for the efficient and accurate refunding of input VAT payments, or the exemption of trade taxes on imported inputs for exporters that fits even a majority of countries. However, we find that systems that reduce the need for such refunds, or rely on information that can be audited are much more likely to be successful than procedures that rely on physical inspections and bureaucratic approvals.

**Table 1: Trade Tax Incentives in Various Countries**

**Africa**

	Ghana	Kenya	South Africa
Duty Drawback	<ul style="list-style-type: none"> <li>• CEPS administers the tax incentive scheme to refund import duties and other taxes charged on imported and local inputs used in the production of exports.</li> <li>• For local inputs, input-output ratio equivalent to imports is used.</li> </ul>	<ul style="list-style-type: none"> <li>• Available to direct and indirect exporters.</li> <li>• A single refund rate for indirect exports was used in 1974 and the program was phased out in Sep. 1993.</li> </ul>	<ul style="list-style-type: none"> <li>• Available for exports outside of the South African Customs Union or BNLS Customs area.</li> </ul>
Duty Exemption	<ul style="list-style-type: none"> <li>• Duty free is for in-bond manufacturing facilities.</li> <li>• Bonds are held equivalent to the amount of the duty/VAT waived on imports.</li> </ul>	<ul style="list-style-type: none"> <li>• Began a duty and VAT exemption in 1990.</li> <li>• Exemptions exclude plant, machinery and equipment.</li> </ul>	<ul style="list-style-type: none"> <li>• Not available.</li> </ul>
Export Processing Zone	<ul style="list-style-type: none"> <li>• Enterprises in free zones are established primarily for exports but may sell up to 30% to domestic markets.</li> <li>• Imports are exempt of indirect taxes and duties.</li> </ul>	<ul style="list-style-type: none"> <li>• Started in 1990.</li> <li>• Had excess capacity in 1993-94.</li> <li>• Accounted for 3.5% of manufactured exports.</li> </ul>	<ul style="list-style-type: none"> <li>• Being considered.</li> </ul>
Bonded Factory/Warehouse		<ul style="list-style-type: none"> <li>• Manufacturing-under-bond in 1988.</li> </ul>	<ul style="list-style-type: none"> <li>• Widely used by manufacturers to defer taxes.</li> </ul>

**Asia**

	Korea	Taiwan	Thailand
Duty Drawback	<ul style="list-style-type: none"> <li>• Became available in 1975.</li> <li>• Refund amount is based on the schedules, calculated from the ratio of import duties and value of previous year's exports.</li> </ul>	<ul style="list-style-type: none"> <li>• Available to direct and indirect exporters.</li> </ul>	<ul style="list-style-type: none"> <li>• Available and the amount of refund is based on the actual duty/tax paid on imports.</li> </ul>

Duty Exemption	<ul style="list-style-type: none"> <li>Available between 1949 and 1975.</li> </ul>	<ul style="list-style-type: none"> <li>Became a very popular scheme in late 1970s and 1980s.</li> </ul>	
Export Processing Zone	<ul style="list-style-type: none"> <li>Two free trade zones were set up in 1970.</li> <li>All materials and machinery and equipment are free of import duty.</li> </ul>	<ul style="list-style-type: none"> <li>The first one was established in 1966 and two more in 1969.</li> <li>Very successful.</li> <li>The share of exports originating from the zones reached its peak in 1974 at approximately 9%.</li> </ul>	<ul style="list-style-type: none"> <li>Established to promote exports.</li> </ul>
Bonded Factory/warehouse	<ul style="list-style-type: none"> <li>Bonded factories were established in 1970. There were about 200 factory areas in 1998.</li> <li>For final products sold in domestic markets, the final products are subject to import duty.</li> </ul>	<ul style="list-style-type: none"> <li>Established in 1971 and the number of factories increased quickly to peak at 371 in 1987 and then declined to around 280 in 1998.</li> <li>For final products sold in domestic markets, the imported materials become duty payable.</li> </ul>	<ul style="list-style-type: none"> <li>The number of bonded warehouses ranged from 112 in 1991 to 144 in 1998.</li> </ul>

### Latin America

	Mexico	Uruguay	
Duty Drawback	<ul style="list-style-type: none"> <li>Available from 1985 to direct and indirect exporters.</li> <li>Beginning in 1999, a deposit in the amount of taxes for refund in Bank is required.</li> </ul>	<ul style="list-style-type: none"> <li>Uses duty drawback scheme.</li> </ul>	
Duty Exemption		<ul style="list-style-type: none"> <li>Temporary admission scheme started in 1912.</li> <li>The scheme is constrained by the Mercosur Treaty.</li> </ul>	
Export Processing Zone	<ul style="list-style-type: none"> <li>Maquiladoras firms are set up for foreign firms in special border zone with the US.</li> </ul>	<ul style="list-style-type: none"> <li>Established in 1913. Eight EPZs are privately managed.</li> </ul>	
Bonded Factory/warehouse	<ul style="list-style-type: none"> <li>PITEX program is set up for domestic firms who would engage in export activities.</li> </ul>		

## **Appendix A: The Experience of VAT Jurisdictions with Tax Relief for Exporters**

### **Asia**

#### **(A) *Korea***

- The VAT in Korea was introduced in July 1977. The effective tax rate was 10%. For small businesses, the tax rate was 2% of gross receipts with no input tax credits. The tax rates remain unchanged.
- The taxable period for VAT is six months, January 1 to June 30 and July 1 to December 31. In each period, there is a preliminary or interim filing period. A trader is required to file his return within 25 days from the date of termination of each of the two interim return periods, January 1 to March 31 and July 1 to September 30. Therefore, a trader has to finalize his tax liability in each of the six-month taxable periods.
- Similar to other VAT jurisdictions, the tax rate is zero-rated for exports. In the early years of the VAT implementation, Korea experienced some serious problems in tax defaults. An example of this was the printing of invoices for registrants to claim input tax credits. This occurred not only with export-oriented firms but also with domestic businesses. The government relied primarily on auditing and penalties to prevent registrants from claiming excess credits. In addition, the government also used the input/output ratio by products, invoice matching and other factors (e.g., why registrants had frequent movement of business addresses) to detect cheating. According to senior government officials in charge of the introduction and administration of the VAT, auditing was the main tool used in Korea to stop excess input tax credits.
- Export-oriented enterprises were audited as frequently as domestic businesses because they could equally reduce the amount of tax payable. Penalty for evasion was 20% of the amount defaulted. Furthermore, interviewees claimed that it would be extremely difficult for exporters to claim refunds without export sales because exporters have to supply the tax authority with an export permit, a credit letter from foreign customers and payment vouchers before tax returns can be processed.
- All imports with no exception are liable for the VAT and payable at the Customs. For imported business inputs used exclusively to produce exported goods, a VAT is imposed on those imports and is payable at the border in the same manner as other imports used to produce goods for domestic markets. There is no special provision in Korea allowing importers for deferring the VAT payment on imports and offsetting the tax as input tax credit when the manufactured products are exported.

- The government used computers to match invoices between registrants in the early years of the VAT implementation. However, due to the large volume of invoices to be processed, the government discontinued this method. Instead, the government used computers to match the total amount of invoices between registrants. This method is less costly because it has substantially reduced the amount of data to be processed. Nevertheless, it is less effective.
- In Korea, data received from VAT, customs, and income tax returns are shared among government departments. According to tax practitioners, the government has encouraged the use of credit cards in recent years. This would link information between financial institutions and governments, making the whole operation more transparent and reducing underground activities.
- The VAT has been run successfully in Korea.

**(B) *Taiwan***

- The VAT was introduced to replace the Gross Business Receipt Tax in Taiwan in April 1986. The standard tax rate was 5% with higher rates imposed on services provided in nightclubs or other entertainment activities. For small businesses, the tax rate was 1% of gross receipts with no input tax credits. These tax rates have remained unchanged since their introduction.
- The VAT adopted in Taiwan is a consumption-type with an invoice credit system. The trader or registrant can claim the input tax paid as credit so long as he has the uniform invoices that are printed and distributed by tax authorities. Unlike other VAT jurisdictions, goods imported by the VAT registrants in Taiwan are not subject to VAT at the time of importation. Instead, the tax is deferred until the goods are sold.
- The taxable period for VAT is bimonthly, where a taxpayer is required to file his tax return every two months by the fifteenth day of the month following the reporting period. Exports are all zero-rated.
- The government uses various methods to detect if there are excess input tax credits being claimed by taxpayers, including refunds by export-oriented firms. The early planning and implementation of computerization for the VAT was emphasized in Taiwan. In particular, the VAT in Taiwan was a sub-national tax where the taxes were collected either by local tax offices on behalf of the provincial government or by two province-equivalent super-municipal governments. To accomplish this successfully, data on tax returns across the country were all sent to the Data Processing Center of the Ministry of Finance in Taipei for process and analysis. In 1999, the VAT was changed to become national tax.
- For years, invoices between input tax and output tax under the VAT have been cross-checked in the Data Processing Center. According to the senior government

officials, nation-wide invoice matching has been successful and it is still working. The government claimed that the VAT collections have been enhanced by this exercise.

- According to the senior government officers, export-oriented enterprises were audited in the same fashion as domestic businesses. Various provisions are made to address noncompliance of VAT. A taxpayer can be penalized from one to ten times of the amount of tax evaded depending upon the case.
- In addition, the government has introduced an incentive program for customers to request invoices. It then operates a lottery where winners are determined based on the invoices selected. The program seems very popular. The extent to which the program has helped tax compliance is an empirical question.
- The VAT in Taiwan appears to be running smoothly as its share contribution to the total tax revenues has been increasing from less than 10% in 1986, to 15% in 1991, and to more than 18% in 1996.

*(C) Thailand*

- The VAT in Thailand is a consumption type VAT with tax credit system extended right through the retail level. The level of threshold is 60,000 Baht per annum. Exempt from VAT are unprocessed agricultural products, farm inputs, educational services, newspapers and books, professional services, health care services, domestic transportation, libraries, museums, zoos, employment services, amateur sports, and renting of immovable properties.
- The VAT rate was 7 percent from its inception on January 1, 1992 to 15 percent in August 1997, 10 percent from August 16, 1997 to March 31, 1999 and has been reduced to 7 percent for two years from April 1, 1999. The rate of VAT is 1.5 percent for those taxpayers whose annual taxable turnover ranges between 60,000 to 120,000 Baht. These taxpayers pay 1.5 percent VAT on their gross receipt and cannot claim for input tax credit. Exports, international transportation, foreign aid programs, UN agencies and embassies are zero-rated.
- A refund may be claimed at the time of filing a return or a supplementary return. There is no need to attach invoice or any other documents with return except for the case in which taxpayers are allowed to file only one return for all branches at the most convenient District Revenue Office that they selected. In this case, taxpayers have to attach documents to show each branch's sales and purchases to the return and to show the combined output and input tax in those return forms. Taxpayers are required to keep tax invoices and other documents with them.
- Claim for a refund has to be submitted to the concerned District Revenue Office. In case of an enterprise having several branches, the claim has to be submitted to

each District Revenue Office unless the Director General has allowed the registrant to submit a single return for all to a specified District Revenue Office.

- In the case of non-registrants, refund claims have to be made at the District Revenue Office located in claimant's domicile. In the case of non-registrant importer (when he re-exports goods on which he has paid VAT at the time of importation), a claim has to be entered at the Customs Office at the time of imports.
- An interest will be paid to the taxpayer at the rate of 1% per month from the day after 3 months from the date of claiming for a refund.
- Refund claims are submitted to the District Revenue Offices, which, in turn, forward refund claims to their respective Area Revenue Offices or Provincial Revenue Offices for the processing of refund. Under the old system, all types of taxpayers were subject to the same procedures. Refund claims were selected for audit randomly. There are both desk audits and field audits, depending upon the case.
- A team of auditors carries out audit, at least two, and the same taxpayer could be audited more than one time by the same team. On average one auditor used to take 9 to 10 days. It was possible to audit more than one month even in the case of refund audit. It was also possible to select taxpayers for general audit that were already audited for refund purpose. Since private auditors certify only the financial statement of the company, but not the tax liability, their reports are not considered for VAT audit.
- Refund claims need to be processed within three months. If they cannot be processed within this time, revenue officers have to take approval from the Chief of Area or Provincial Revenue Office for an extension of up to two months.
- In the beginning, revenue authorities took a liberal attitude in order to be friendly with the taxpayers. Refunds were made first without any audit in order to provide refund in a quick manner. Taxpayers took undue advantage of this situation. Many applied for refund on the basis of fake invoices. A number of companies were set up to produce fake invoices. They used to sell such invoices around 60% of the stated values. After some time, revenue authorities realized that the refund mechanism had been abused widely by the taxpayers. They became strict on this matter and adapted a policy to check refund claims thoroughly before any refund is made. But it is very difficult to process a large number of refund claims on time. As a result, exporters who really needed refunds suffered the most. Until recently, small taxpayers, large taxpayers, exporters, and local sellers were all subject to the same procedures.
- The procedures of the VAT auditing system were cumbersome and personnel were inefficient and weak in Thailand. There had been a great number of taxpayers who



applied for refunds on the basis of fake invoices. This occurred due, in part, to lack of auditing in order to provide speedy refunds for taxpayers. The revenue authorities have revised the refund process in the first quarter of 1999 in order to solve the problems associated with the VAT refund. The new system intends to process the claims submitted by the exporters in a quick and easy manner. Under the new system, Revenue Offices will create separate database for the exporters and the others. Withholding and Refund Division of the Area/Provincial Revenue Office will separate refund claims into three categories: exporters, irregular requests for refund, and normal request for refund.

(a) Exporters: Taxpayers having 50% or more of their total transactions as export will be included in this category. They have to have exports almost every month and they will be claiming for refund almost every month. The documents required proving exports include export declaration form, receipt of payment, and other related documents from Bank, if any. Some taxpayers such as providers of international services, which are not exporters but supply zero-rated services, are included in the exporter's group.

Exporters are further divided into three groups. The first are exporters with loss for a continuous period of three years for the corporate income tax purposes. Their records are audited before approving refunds. The second are top 10 exporters in Thailand. In case of doubts, copies of their returns are sent to the responsible officers. The third are other exporters. Whether or not their records will be audited will depend upon the judgment of the officials.

(b) Irregular request for refund: Irregular refund claims are included in this category. For example, a taxpayer making local sales claims refund continuously for three months, or a taxpayer whose purchase tax is higher than output tax by 90%. Since criteria for identifying irregular taxpayers will change every year, the taxpayer will not know about them.

(c) Normal request for refund: They are suppliers of goods and services in the local market or exporters who are not included in (a). These taxpayers are divided into three groups: (i) New VAT registrants: they receive notices of delay in refund. They have to wait for 6 months. Their records are audited by audit operation in order to give advice for the right way to record or keep accounts and documents. (ii) Exporters not included in the database: their records are not audited but only evaluated, such as through a visit of the sites, observation of factories, checking stocks, etc. (iii) Taxpayers whose input tax is higher than output tax by 25 %. Their records are not audited but only evaluated.

## **Africa**

### **(A) *Ghana***

- VAT was first introduced in Ghana in 1995 but was withdrawn after only three and half months of implementation. The tax was re-introduced on December 30, 1998 at a single rate of 10 per cent. Only exports and ships' supplies are zero-rated.
- A new VAT Service has been established to administer the law, bringing the revenue agencies to three. The others are Customs, Excise and Preventive Service (CEPS) and Internal Revenue Service (IRS). However, all three agencies are to operate under the general supervision of the newly legislated National Revenue Agencies (Governing) Board (NRAGB), the equivalent of a revenue authority.
- Like other VAT jurisdictions, firms in Ghana selling taxable supplies are allowed to set off the VAT paid on purchases and expenses against the VAT charged on sales. This mechanism applies to both domestic supplies and exports since for purpose of the tax, zero-rating is classified as a taxable supply.
- The credit scheme for regular business transactions is subject to the following conditions:
  - Providing evidence in the form of a commercial invoice or customs entry (in the case of imports or goods removed from a bonded warehouse);
  - No input tax may be deducted after the expiration of a period of 3 years from the date the deduction accrued;
  - Where taxable and exempt supplies are involved, the input tax must be apportioned or attributed in a fair and reasonable manner;
  - The input tax with respect to the provision of entertainment and the supply or import of motor vehicles or vehicles spare parts is non-deductible.
- Ghana's VAT law has special conditions for refund of input taxes, where these exceed the output tax. First, in the case of firms that export more than 70 per cent of the total supplies within the accounting period, the refund shall be made within thirty days. Second, in other cases, refund will be made only when the excess remains outstanding for a continuous period of three months or more.
- A firm that holds stocks of goods or capital items before registration may claim a credit or refund in transition as follows. First, in the case of goods held for resale, the supply or import should have occurred not more than four months prior to registration. Second, in the case of capital goods, the goods should have been held for a period not exceeding six months from the date of registration.

- There is no provision for remission of the tax in law, but machinery purchased for agriculture, mining, industry and railways is exempt from payment of VAT.

**(B) Kenya**

- VAT was introduced in Kenya in 1990. The tax began with multiple rates, and though these have been reduced, Kenya to date implements a 3-rate regime. It is also among the few African countries that have introduced the tax with a relatively large number of domestic supplies being zero-rated. The VAT Department replaced the Sales Tax Department as a separate unit of the civil service but is now integrated into the single administrative structure established under the Kenya Revenue Authority (KRA).
- The credit invoice system operates in the same manner as other VAT jurisdictions. Nevertheless, the credit scheme for regular business transactions in Kenya is subject to the following conditions:
  - No input tax may be deducted more than six months after that input tax became due;
  - The excess of input tax over output tax shall be carried to the following months;
  - A refund is subject to the Commissioner being satisfied that it is a regular feature of the business; and
  - Where taxable and exempt/relief supplies are involved, the input tax must be apportioned or attributed in a fair and reasonable manner.
- The Kenyan tax regime incorporates a remission scheme, including VAT targeted at either attracting investment or promoting exports. They include the following:
  - A duty/VAT remission scheme for firms that import inputs under the Manufacturing Under Bond (MUB) and EPPO program;
  - The Minister may also remit the tax in the public interest under specific circumstances.
- Under the original VAT law introduced in 1990, imports made by MUB are *zero-rated* to avoid the payment of VAT up front. The zero-rating incentive has since been extended to domestic supplies made to MUBs to encourage local firms to sell to these enterprises.
- Export processing zone enterprises are exempt from registration under the VAT Act because they are not considered as local firms. They are also exempt from the payment of excise duties as specified in the Customs and Excise Act. The sales made by domestic firms to EPZ companies would be zero-rated; on the other hand, goods sold by EPZ companies to the domestic market would attract import VAT.

(C) *South Africa*

- VAT was first introduced in South Africa in 1991 and has undergone a number of reviews. In addition to exports and ship's supplies, South Africa also zero-rates domestic supplies of certain agricultural products. The administration of VAT is being gradually incorporated in the new South African Revenue Service (SARS). The VAT was introduced at 10 percent against a proposed rate of 12 percent. However, the standard rate has since risen to 14 percent.
- It is a credit invoice system. The credit may be allowed upon the production of a tax invoice or customs entry but input tax credit may be disallowed after 5 years, starting from the period when the right to claim the credit arises.
- The country has experienced credit fraud in relation to supplies made within South Africa, ostensibly for export overseas. The worst cases have been associated with goods exported to neighboring countries, including the BNLS and SACU states. Consequently, a number of measures have been taken to curb revenue losses arising from these fraudulent refund claims.
- The measures to check the credit and refund frauds include: (a) the use of approved air, sea, and land customs entry and exit points; (b) in the case of itinerant exporters, making refunds at the border when the customs officials are satisfied that the goods are leaving the country; and (c) intensification of audits and exchange of information with countries in the customs union.
- A firm that holds stocks of goods or capital items before registration may claim a credit or refund depending on the circumstances of each case. Since South Africa had a retail stage sales tax before the introduction of VAT, the goods held at the time of introducing VAT did not pose many problems for the authorities. Nonetheless, credits were allowed for input tax in the case of taxpayers who may be entering the net for the first time.
- South Africa has an elaborate routine and non-routine audit process with audit cases being generated by a computerized program. It spans information visits, desk examinations, and in-depth field audits. Areas of high audit risks such as export and other zero-rated refunds, new taxpayers filing for refunds at first filing of returns, and refunds involving capital items are given higher risk points in the program. The audit process has a stated goal of completing a cycle for all taxpayers in three to four years. Though no elaborate program exists for matching invoices, officers are trained to follow the trail diligently, sampling invoices for compliance for each audit assignment. The informal and managerial linkages established between VAT and income tax/customs is to be transformed into an elaborate management information process under SARS. The Service takes the imposition of penalties on default cases seriously to serve as a deterrent.

## Latin America

### (A) *Mexico*

- The VAT was introduced in January 1980 at a single 10% rate with a destination principle and an invoice credit system. There were zero-rate provisions applied only to exports and exempt provisions applied to a few commodities such as agricultural products. However, the VAT rate has been changed several times since its inception. In 1983, the 10% rate was raised to 15%, the general rate, with two special rates, 6% being imposed on medicine and agricultural products and 20% being applied to cable services among others. In 1991, the 15% general rate was brought down to 10% with a zero rate for exports. In April 1995, the 10% rate was raised to 15% again but kept the 10% rate imposed on goods and services sold in the border zone, which was generally mentioned in public documents as the area 20 kilometers from the U.S. border. According to the law, the definition of the border zone appears to be more sophisticated (e.g., one area of the zone is in fact located in the southeast, far away from the border).
- In addition to exports, zero-rate is currently applied to basic food, medicine, milk, and business inputs used in the production of agricultural sector (e.g., fertilizer, farming machinery, and equipment). There are many exempt goods and services. Examples include books, magazines, houses, residential rents, education services authorized by educational institutions, medical and other health services, taxi, urban transportation bus services, financial intermediation services, life insurance, and insurance for agricultural risk.
- It should be noted that transportation services including rail, marine, domestic flight and bus services between cities are all taxed at the general rate, while international flights are taxed at 25% of the general VAT rate. International freights are zero-rated while domestic freights are exempt. Like New Zealand, general insurance such as property and casualty premiums is taxed at the general rate. In the case of personal loans, interest payment on the portion of real interest rate is subject to the general rate. Mortgage and business loans are exempt. This may be a source of abuse by financial institutions in claiming excess input tax credits related to taxable personal loans. Finally, there is a high small business threshold that is equivalent to US\$100,000 of annual turnover.
- For a firm that produces taxable and exempt products, input tax credits used to be based on own judgment of VAT registrants. However, the credits can now be claimed according to the proportion of taxable sales beginning in 1999. This has caused the business community quite a bit of concern due to the increase in their compliance costs. For example, the allocation of input tax credits applies to some construction firms –(engaged in business and residential construction) and financial institutions –(undertaking life and property and causal insurance).

- Like other VAT jurisdictions, imports in Mexico are taxed at 15% and collected at the time of importation unless they are destined for the border zone, which are subject to 10%. For goods that were originally destined for the border zone and subsequently shipped to the rest of the country, an additional 5% VAT rate is imposed and collected at the border that is located at 26 kilometers from the U.S. border. One issue is how effective the control would be when imported goods was initially claimed destined for the border zone, but the final destination is south of the border zone.
- Exports of goods or services are all considered zero-rated under the VAT system. Export-oriented firms are entitled to receive input tax credits within 40 or 50 days from the time they file their tax returns. Beginning in 1999, the tax authority (SAT -- Servicio de Administracion Tributaria) has announced new rules, indicating that firms who request tax refunds may deposit the amount of the refund in special bank accounts until the government is comfortable with the claim. This scheme applies to all export-oriented firms as well as other firms who request tax refunds. Such deposits may not be required for firms that have good records in their businesses. Thus, the requirement for bank deposits is very much based on the discretion of the tax authority. Nevertheless, it is one step of tight control in input tax credits under the VAT system. The scheme also applies to refunds related to income tax or other taxes.
- As of 1999, there were approximately 6,000,100 VAT registrants in Mexico. Approximately half the registrants were monthly filers and the remainders were quarterly filers. Taxpayers may pay their taxes to banks or the government directly. Monthly filers have to file their returns by the 17<sup>th</sup> of the following month. If a taxpayer files for tax refunds, he will receive the refund in two months. Exporters can receive refunds in a month. For firms who have the status of the ALTEX program (i.e., the high volume exporting companies program), refunds can be received in 10 working days.
- Large corporations with excess input tax credits may use this credit to offset income tax liability provided their tax returns and financial statements are prepared and signed by Chartered Public Accountants.
- Until late 1999, the government had not used computers to monitor changes of individual tax liabilities such as the ratio of business inputs to output for respective industries. Nor did the government crosscheck tax and other data between VAT, Customs, and income taxes. However, cross-checking information between taxes has been in operation for six months through a new computer system. For example, 158,287 taxpayers were cross-checked for their 1997 tax returns between VAT and Income Taxes. In Mexico, the same taxpayer has one tax identification number.
- There is no special distinction in terms of auditing between export-oriented and domestic firms in Mexico. No systematic random sampling of firms is undertaken

for auditing. Only particular taxpayers will be audited if they present special problems in view of government officials. In 1998, there were 721 thousand taxpayers subject to auditing and about 18 million pesos of VAT was recovered.

- VAT has been a very important revenue source for the federal government in Mexico. Over the past 12 years, VAT has accounted for more than 30% of the total federal tax revenues, with the exception for the period 1992 to 1994 in which the VAT rate was imposed at a 10% rate. It is also important to note that the proportion of VAT collected at Customs has increased over time from 25% in 1987 to 48% in 1998. This could be the result of the recent openness of the Mexican economy and a tighter control of the customs operations.

**(B) *Uruguay***

- VAT was introduced in Uruguay in 1967. It has two tax rates: one is 14% for a few processed foods and medicines; and the other is the general rate of 23% for the rest of goods and services. Exports are zero-rated and excess credit on VAT is refunded.
- The number of VAT refunds amounted to 16 million during 1998 and 80% of them were to exporters. The Tax Administration Directorate issues these refunds and its process is fully computerized.
- The relevant VAT information is shared among the Tax Administration, the Social Security Directorate, and Banco Republica, the largest and state-owned bank. In 1998, about 35,000 refunds were issued and they can be applied against internal taxes or security contributions. The auditing procedures are on a random basis: 5% of the total refunds issued and all the first time requests for new exporters are audited.
- In 1998, there was a falsification of the documents for US\$5 million. There was also a sophisticated fraud on the VAT withholdings by the meat pack industry, linked to the production of zero-rated unprocessed meat, for almost US\$2 million.

## **Appendix B: Country Examples of Trade Tax Relief for Exporters**

### **Asia**

#### **(A) *Korea***

- To promote exports in early years, Korea established free trade zones, duty drawback, and bonded factory systems.
- There were two free trade zones established in 1970. Within the zones, all imported raw materials, machinery, and equipment are free of import duty.
- The customs duty exemption and reduction system in Korea was adopted in November 1949 to promote investment plants and machinery of certain industries where goods were in shortage. The system was first extended in 1974 to machinery, electronics and heavy chemical industries and then to the functional reduction systems, beginning in 1983 for R&D, scientific research, automation for the factories, environmental protections and human resource development. This is more in line with the industrial policy rather than the measures aimed at export promotion.
- For export promotion, the duty exemption also applied to raw materials in Korea during the period between 1949 and 1975 on the condition that they would be processed in the final products for exports. Due to concern for government revenues, the exemption system became available for selected commodities only. The duty relief system was generally replaced by the duty drawback system in 1975 because imports were rising and inspections were required at the border.
- With the duty drawback system, customs duties and sales taxes are imposed on imports at the border and they can be refunded when the raw materials are manufactured and the final products are exported. The products have to be exported within two years of the date of importation of the raw materials. The amount of the refund is claimed according to the schedule of fixed drawback rates, based on the customs duties and taxes as well as the value of exports of the previous year. For goods not listed on the schedule, the amount of the refund is based on the customs duties and taxes paid on imported materials and the certificate of export declaration of the products. Applicants for refunds can be exporters or persons who supplied the final products to exporters, bonded factories, or free trade zones.
- The amounts of customs duty drawback expressed in millions of won were 967,700 in 1993, 1,005,900 in 1994, 1,219,700 in 1995, 1,425,600 in 1996, and 1,262,500 in 1997.
- Korea established bonded factories in 1970. Within the factories, imported raw materials are duty exempt. There are 200 factory areas (not factories).



- It is interesting to note how the tax is treated in Korea when the products from the bonded factories are shipped for domestic consumption. Suppose 30% of the materials processed in a bonded factory are imported and their duties are therefore exempt. Also, suppose the final products valued at the factory gate are US\$100 and they are all sold at the domestic markets. The amount of the final products subject to import duty is US\$30 and the rate of duty is the duty rate of the final product. The treatment is different from that in Taiwan. Instead of imposing a tariff rate on the final product, Taiwan does not provide tax exemption for imported materials. That means the imported materials become duty payable when the final products are sold at domestic markets.

**(B) *Taiwan***

- The duty relief system has been implemented for a number of years in Taiwan. The schemes are operated through either duty drawback or duty exemption in order to provide incentives to export-oriented firms. The duty exemption also applies to export processing zones, bonded factories, and science-based industrial parks.
- Unlike Korea, Taiwan has both the duty drawback and duty exemption systems operating concurrently. In the case of the duty drawback system, an importer pays import duty first and then claims a refund later once the finished products are exported. Because the duties have been paid upon importation, refunds can be claimed by importers, exporters, or manufacturers of exported goods. The actual operation of this system is very similar between Taiwan and Korea. In the case of the duty exemption, it is an account-offset system and can therefore be claimed by importers alone. The latter case became more popular in Taiwan in the 1970s and early 1980s. The figures can be found in Table B-1.
- The duty relief scheme was expanded from the relief of import duty to commodity tax, harbor contribution dues, salt tax, and slaughter tax.
- There were three export-processing zones established in Taiwan. The first one was established in Kaohsiung in late 1966. Within the zones, no import duties are levied on imported raw materials and equipment. In addition, the zones have their own taxation, banking, power, water and export facility. This makes the operation much more simple and efficient. This became very attractive to foreigners and overseas Chinese investors. Exports from the zone increased rapidly. As a result, two additional zones were established in 1969. While much has been written about the success of the zones in Taiwan, the share of exports originating from the zones reached its peak in 1974 at approximately 9%. Details can be found in Table B-2.
- Taiwan established bonded factories in 1971. Within the factories, duty relief on imported raw materials is operated under the exemption or the accounts offset

system. The number of factory areas increased quickly from the initial 68 firms in 1971 to the peak of 371 in 1987, declined to 265 in 1996, and then increased to 281 in 1998.

- Although the bonded factories were set up for exports, the factories are required to pay duty on imported materials in case the products are sold in domestic markets. This would place the bonded factories on an equal basis with other domestic manufacturers. Nevertheless, the treatment is not quite the same as in Korea.
- The concept of the bonded factory was further extended to the science-based industrial parks in Taiwan in 1980 in order to promote the development of their science and technology. The tax incentives provided to the parks are the same as those in the export processing zones. Some professionals claimed that the recent development and growth in the semiconductor and electronics sector (the most important export sector in the 1990s) was largely attributed to the parks.

**Table B-1: Duty and Tax Relief for Exports by Mechanism in Taiwan**

Year	Number of Cases (#)	Amount of Reliefs		
		Refunds	Accounts Offset	Total
		(Thousands of NT dollars)		
1967	23,189	300,685	1,250,897	1,551,582
1968	29,067	352,687	1,724,751	2,077,438
1969	68,241	423,455	2,901,801	3,325,256
1970	208,834	977,983	5,923,351	6,901,334
1971	205,602	1,169,179	7,406,267	8,575,446
1972	258,913	1,624,022	10,745,146	12,369,168
1973	308,300	2,035,524	10,728,299	12,763,823
1974	323,398	2,366,621	13,766,253	16,132,874
1975	287,000	2,183,168	11,074,480	13,257,648
1976	400,705	2,898,619	15,642,673	18,541,292
1977	477,992	3,601,657	16,984,202	20,585,859
1978	545,032	5,389,532	14,758,448	21,147,980
1979	718,115	8,635,532	21,231,174	29,866,706
1980	665,367	9,632,334	20,186,387	29,818,721
1981	637,244	9,741,034	14,450,888	24,191,922
1982	729,598	11,356,202	14,432,091	25,788,293
1983	675,662	9,310,096	12,669,148	21,979,244
1984	661,481	10,853,821	17,781,339	28,635,160
1985	565,332	10,967,146	15,347,343	26,314,489
1986	551,075	9,722,984	10,665,202	20,388,186
1987	648,655	10,708,098	9,949,287	20,657,385
1988	559,878	8,453,650	6,122,761	14,576,411
1989	309,036	4,107,172	3,176,328	7,283,500
1990	208,466	2,878,327	2,122,026	5,000,353
1991	175,847	2,493,815	1,669,923	4,163,738
1992	181,543	2,753,561	1,358,522	4,112,083
1993	156,715	2,581,070	1,170,528	3,751,598
1994	148,447	2,482,493	1,027,840	3,510,333
1995	160,759	3,198,730	975,524	4,174,254
1996	160,015	3,617,335	1,360,553	4,977,889
1997	141,070	3,390,000	1,120,000	4,510,000

Sources: Department of Customs Administration, Ministry of Finance. Internal Document (1998).

**Table B-2: The Relative Importance of Exports in Export Processing Zones in Taiwan**

	<u>Total</u> <u>Nation</u>	<u>Export Ratio of</u> <u>EPZs to Nation</u> (millions of US dollars)	<u>Kaohsiung</u>	<u>Nantze</u>	<u>Taichung</u>	<u>EPZs</u> (%)
1967	7	n/a	n/a	7	641	1.09
1968	27	n/a	n/a	27	789	3.42
1969	62	n/a	n/a	62	1,049	5.91
1970	109	n/a	n/a	109	1,481	7.36
1971	156	2	5	163	2,060	7.91
1972	196	16	16	228	2,988	7.63
1973	282	54	40	376	4,483	8.39
1974	348	92	69	509	5,639	9.03
1975	290	92	71	453	5,309	8.53
1976	393	146	137	676	8,166	8.28
1977	417	166	167	750	9,361	8.01
1978	473	227	206	906	12,687	7.14
1979	602	325	278	1,205	16,103	7.48
1980	685	402	337	1,424	19,811	7.19
1981	821	432	426	1,679	22,611	7.43
1982	724	493	408	1,625	22,204	7.32
1983	750	475	396	1,621	25,123	6.45
1984	938	629	470	2,037	30,456	6.69
1985	872	635	365	1,872	30,726	6.09
1986	949	1,010	444	2,403	39,862	6.03
1987	1,244	1,400	530	3,174	53,679	5.91
1988	1,356	1,773	637	3,766	60,667	6.21
1989	1,397	1,948	664	4,009	66,304	6.05
1990	1,026	1,921	578	3,525	67,214	5.24
1991	1,094	2,198	678	3,970	76,178	5.21
1992	1,217	2,279	674	4,170	81,470	5.12
1993	1,107	2,628	591	4,326	85,092	5.08
1994	1,156	2,956	668	4,780	93,049	5.14
1995	1,447	4,025	800	6,272	111,659	5.62
1996	1,484	4,579	834	6,897	115,942	5.95
1997	1,545	5,421	969	7,935	122,081	6.50
1998	1,280	4,122	692	6,094	n/a	n/a

Sources: Ministry of Economic Affairs, Export Processing Zones, Monthly Statistical Reports, (1998).

Council for Economic Planning and Development, Taiwan Statistical Data Book, 1998.

(C) **Thailand**

- Taxes and duties paid on the import of raw materials used in the production of exports are refunded to the entrepreneurs. In order to get refunded, goods must be exported within one year of the importation of raw materials. Drawback must be refunded within the specified time mentioned below:

<u>Type of Entrepreneur</u>	<u>Time limit within which drawback must be granted</u>
the entrepreneurs using a bank's guarantee	within 5 minutes
special-grade customs brokers	within 1 day
good-grade customs brokers	within 15 days
special-grade exporters	within 15 days
good grade exporters	within 20 days
general drawback applicants	within 30 days

- The amount of duty draw back is paid on the basis of the actual duty/tax paid on imports. There are no average rates fixed for this purpose. Refund made between 1993 and 1998 is given in Table B-3.

**Table B-3: Tax refund**

(millions of Bahts)

<u>Year</u>	<u>Number of tax refund claimed</u>	<u>Amount of tax refunded</u>	<u>Value of exports on which refunded</u>
1993	262,332	18,616	268,158
1994	357,160	18,942	451,609
1995	383,415	17,369	649,267
1996	369,997	15,725	754,661
1997	424,698	13,133	945,860
1998	NA	13,398	NA

Source: Customs Department

- There is also a provision of the duty and tax compensation. Under this system, exporters can file for tax and duty compensation for the exports already made. The compensation covers duties and taxes levied on raw materials, spare parts, machinery and equipment, fuels, and other energy used in the production of exports. The compensation rates are determined by a special committee, using cost of production data supplied by exporters. The following sales are covered under this scheme:

- Sale of goods to the government agencies or state enterprises receiving the international loans or assistance;
  - Sale of goods to person eligible to diplomatic privileges; and
  - Sale of goods to the international organizations eligible to importing goods into the Kingdom with the exemption of duty.
- Export processing zones have been established to promote exports. Industries located in EPZs get duty and tax exemption for export production. No duties and VAT are levied on materials, machinery, or equipment used in the production in the EPZs. Firms in EPZ do not fulfill the customs formalities at the import or export points; they can complete these formalities at the customs unit set up at the EPZ itself. Tax exempted under the EPZ exemption from 1993-98 can be seen in Table B-4:

**Table B-4: Export Processing Zone**

(millions of Bahts)

Export	Value of Raw Materials		Amount of Tax	Value of
	<u>Year</u>	<u>And Machinery Imported</u>	<u>Exempted</u>	<u>Production</u>
	1993	6,229	5,065	22,372
	1994	35,195	10,792	41,628
	1995	55,427	12,616	61,387
	1996	76,081	11,670	84,968
	1997	107,831	11,137	101,432
	1998	112,658	14,555	149,085

- There is a provision for the establishment of bonded warehouse under the Customs Act. Under this system, raw materials can be brought into production without paying duties and taxes. Businesses are required to give bonds to the Customs Department. There are five categories of bonded warehouses: manufacturing, basic raw material, packing or repackaging, repair or construction of vessels, and duty-free type. The total number of bonded warehouses was 112 in 1991, 115 in 1992, 108 in 1993, 119 in 1994, 134 in 1995, 130 in 1996, 127 in 1997 and 144 in 1998. The amount of tax exempted for manufacturing bonded warehouse is shown in Table B-5.

**Table B-5: Manufacturing Bonded Warehouse**

(millions of Bahts)

Export Year	Value of Raw Materials And Machinery Imported	Amount of Tax Exempted	Value of Production
1993	55,043	20,183	75,466
1994	67,003	16,421	86,070
1995	87,020	18,621	102,795
1996	66,402	14,144	92,643
1997	60,574	10,529	79,793
1998	92,181	17,562	128,806

- The electronic data interchange projects started in early 1998 at some selected points. The system is expected to be installed at all import and export points by the end of 1999.

## **Africa**

### **(A) Ghana**

- The Free Zones Board is charged with the responsibility of licensing, assisting, and monitoring applicants who wish to develop the facility. Any company or partnership may apply for a license to establish an enterprise in the zone. The enterprises are established primarily to export but may sell up to 30 per cent of its supplies on the domestic market. The law exempts the imports of a free zone developer, sub-contractor, or enterprise from direct and indirect taxes and duties. The law empowers the Minister to issue regulations specifying that goods in transit into and out of the free zone area shall be covered by bond issued in favor of the customs authorities.
- Customs, Excise and Preventive Service (CEPS) administers a duty drawback scheme for exporters. The scheme aims at refunding import duty, excise duty, and other taxes charged on imported as well as locally purchased inputs incorporated in exportable products. The scheme has been operating in Ghana for a long time and CEPS Law in 1993 has been streamlined to make it more effective. The goal of the drawback is to make local firms that export competitive by removing domestic taxes from their costs.
- The operation of the duty drawback scheme has now been extended to indirect exporters. Proof of import in the customs documentation must show that the imports were consigned directly to the claimant. The exporter can endorse the right to a drawback to the third person in the production chain.

- CEPS has established a special Duty Drawback Bureau (DDB) to ensure smoother operation of the scheme. The taxpayer seeking to re-claim duty and other taxes paid on “materials” is required to submit a statement of composition application on the appropriate form to CEPS at least ten days before the manufacture for export starts. The statement of composition establishes the drawback rate (input/output ratio) to be applied when an application for the actual drawback is later submitted. The drawback claim submitted must also include “proof of export” – the customs entry or landing certificate.
- There is the in-bond manufacturing (IM) facility, also aimed at exporters. CEPS would allow an IM to import inputs into the country without payment of duty/VAT, warehouse under bond, convert them and then re-export the final product. The finished goods should be re-exported within 2 years after the bond was established. The main objective of the scheme is to prevent cascading of the import duty and ease the liquidity of firms. In this regard, IM is considered superior to drawback since it assists firms to be more competitive.
- To operate the scheme, a firm must apply to CEPS for a license and the premises placed under bond. The bond is often equivalent to the duty waived on the imported items. CEPS has resident officers in almost all these premises to ensure compliance. Though the facility is primarily available to exporters, the goods produced may be put on the domestic market after the payment of the appropriate duties and VAT on the finished product.
- The law allows local manufacturers who sell to IM firms to claim drawback as indirect exporters for the duty/VAT paid on the materials. However, this can be done after the finished goods have been appropriately entered by CEPS for exports by the purchaser. Also, goods held in a bonded warehouse may be transferred without the payment of duty to an IM facility.

**(B) Kenya**

- The main trade tax incentive schemes include export compensation, duty drawback, manufacturing under bond (MUB), and export processing zones.

*Export Compensation Scheme*

- The Export Compensation Scheme (ECS) was introduced in 1974 but was phased out in 1993. It operated as a simplified form of duty drawback. It replaced the conventional duty drawback schemes administered by the customs administration, which were considered difficult to comply with at the time. It is important to note that it overlapped the duty/VAT remission scheme that was introduced in 1990. This latter scheme is now considered to be superior; hence the scrapping of ECS. Under ECS, exporters received direct cash compensation of 15 - 18 percent of the value of exports as compensation for taxes presumed to be paid on inputs.



- The main advantage of the scheme was administrative feasibility since it depended solely on verifying export data and documentation (e.g. customs, shipping, and banking data). The scheme contrasts with the conventional duty drawback schemes that rely on input-output ratios and their verification to determine the amount of refund or credit given to exporters. The Act established a list of exportable goods that were eligible for refund under the scheme but it gave discretionary powers to the Minister of Finance to approve goods that are not listed after satisfying specified conditions. The conditions include a minimum of 30 percent domestic value added and duty on up to at least 20 percent of inputs.
- The main disadvantage of ECS is that the amount paid is not directly related to the actual amount of inputs used, thus over-compensating firms with low levels of imported inputs. In effect, these firms receive a subsidy at the expense of firms with high imported input contents – for whom the 18% compensation limit may not be adequate. In addition, it offended WTO/GATT rules on countervailing taxes. The absence of rules to match output against inputs utilized implies that ECS potentially provided relief from import duty for all inputs, raw materials as well as capital costs.

#### *Manufacturing Under Bond*

- The MUB scheme was established in 1988 to boost exports as part of the adjustment programs introduced earlier in 1987. It is a duty or tariff deferral scheme under which eligible firms were licensed, placed under bond and allowed to import capital items, spares, and raw materials without payment of duty. The bonds may be established on behalf of the firms by commercial banks or insurance companies. The amount of the bond is predetermined for each import, with the customs authorities canceling it when the firms make exports, using the inputs on which the tax was waived.
- A firm must invest up to Ksh 10 million and employ a minimum of 100 people to qualify for an MUB status. The goods produced can only be sold on the domestic market with the permission of the Commissioner. When goods are sold on domestic market, the firm becomes liable for the equivalent import duties waived on the inputs used to manufacture the goods. The physical controls that exist for monitoring their inputs and output are similar to those used under excise regimes.
- Over 70 MUBs were operating in Kenya by 1993, exporting mainly garments to the US market. Though the scheme continues, the number of firms has declined drastically to about 12 when, in 1994, the US trade authorities revoked Kenya's export quota to that market. They cited abuse that involved transshipment of cargo from India through Kenya as the reason for the revocation order.

### *Export Processing Zone*

- The EPZ Act was enacted in 1990 to establish the EPZ Authority (EPZA) as a “one-stop” centre for facilitating export-oriented investment and administering a number of incentives. The incentives offered by the Authority cover trade as well as income taxes. EPZA is also an executing agency since it manages the government-owned free zone parks. Most of the parks are, however, owned by private firms. The number of industrial parks administered by the Authority has risen from 7 to 16 between 1993 and 1998. Similarly, the number of EPZ firms has increased from 13 to 22 within the same period.
- EPZ operations in Kenya conform to the general rule that such facilities operate outside the country’s customs territory. Hence, the firms may import goods – capital and other inputs – into the zone without the payment of customs duties and VAT. Eligible items include machinery and equipment, spare parts, tools, raw materials, intermediate goods, construction materials, and equipment. Sales made by domestic enterprises into the zone are considered as exports. The reverse flow would be imports for customs and VAT purposes. The scheme also exempts licensed firms from a number of local charges and exchange control regulations, though some of these have lost their attractiveness with the extensive liberalization of the economy and the subsequent repeal of various control regime laws.
- The EPZ companies are allowed to sell up to 20 percent of their products on the domestic market. However, this rule was not rigidly applied during the early years of the scheme, with domestic sales sometimes exceeding 50 percent. To prevent the EPZ benefits from giving undue disadvantage to domestic firms, an additional 2.5 – 5 percent import duty is charged on EPZ sales made to the domestic market. Another constraint for EPZ operations in Kenya is that because EPZ firms operate outside Kenya’s customs territory, the preferential tariff regime they would have enjoyed in marketing to the Common Market for Eastern and Southern Africa (COMESA) countries is blocked. This is considered to be a major disincentive for expansion of the scheme since many Kenyan firms target the COMESA market.
- The EPZ incentives encourage the participation of the private sector in the development of processing zones. To date, EPZA has gazetted 16 zones but only half are in operation. Indeed, of the eight industrial parks and processing companies that are operating now, only one – developed by the World Bank and the Kenya Government – is publicly owned. A second one is planned but has not taken off yet. Currently, the capacity in the parks outstrips the pace at which EPZ companies are being established. Companies covered by the scheme directly employ approximately 3,500 people.
- The general views among officials and researchers appear to suggest that the EPZ policy has performed below expectation. Though their operations are more diversified than under MUBs, exports by EPZ companies accounted for only 3.5 percent of total manufactured exports. Employment is approximately 1 percent of

the manufacturing sector's workforce. Fourteen out of the approximately twenty firms operating in the zone are either fully or substantially owned by foreign firms. Most of the foreign direct investments are from the UK, which accounts for nearly 60 percent of the total capital investment in EPZ firms in Kenya.

#### *Duty and VAT Remission Scheme*

- The tariff and VAT remission scheme was introduced in 1990 to provide relief from the payment of these taxes on imports of raw materials and other inputs that physically form part of the goods exported. Unlike the MUB and EPZ schemes, the remission mechanism does not cover taxes paid on capital inputs such as equipment and machinery.
- Firms that wish to use the scheme are required to apply to the Export Promotion Programmes Office (EPPO) of the Ministry of Finance. In the case of regular exporters, the application should be supported with data showing evidence of import and export activity for the preceding three years. Other information required includes input-output production data and an estimate of the value of imported raw materials to be used. On the other hand, occasional exporters are only required to produce evidence of a firm order and letters of credit or other form of payment. The approval to import without paying duties remains open for nine months and may be extended for a further nine months.
- The approval given by EPPO allows the firm to import materials used for processing exportable products without the payment of duty or import VAT. Thus, the remission scheme is an *ex ante* tax waiver or exemption mechanism that appeals favorably to firms because of its liquidity advantage over the conventional drawback system. Moreover, it has wider application since the scheme is available to both direct and indirect exporters (e.g., imported inputs used in manufacturing packaging materials for exporters). Another application is that firms who supply the equivalent of exempt finished products or sell to exempt institutions (e.g., armed forces, aid-funded projects etc.) may also apply to use the scheme in order to remove the bias in favor of importers.
- When the application is approved by EPPO, the firms are required to establish a bond in favor of the Commissioner of Customs and Excise Department, equivalent to the duty and VAT remitted. After the goods have been exported, the beneficiary firms then reconcile their actual utilization of raw materials with the declaration made at the time of filing the application with EPPO. Once the Commissioner is satisfied that the exports have taken place or duty paid for unutilized inputs, the bond will be cancelled. Firms are allowed to apply for an extension of the period of use, renewable for an additional nine months – making the upper limit for all applications 18 months.

- EPPO is now a facilitating unit that approves the application to use the scheme though it made use of staff seconded from Customs and Excise Department of the Kenya Revenue Authority (KRA) to perform the initial audit of statements and inspection of sites. The Department is now directly responsible for performing this function. However, to clear the backlog of reconciliation cases that piled up between 1993 and 1995, a private inspection company was engaged to audit the reconciliation statements filed by firms. This contract lapsed in 1998.
- Unlike EPZ companies, EPPO firms may sell to the attractive COMESA market because they are classified as local firms. Currently, approximately 350 firms use the scheme, with about one-eighth classified as regular exporters. Another quarter is classified as periodic exporters with the remainder categorized as occasional exporters.

*(C) South Africa*

- The major trade tax incentive is the duty drawback program. Duty drawback is available to manufacturers who import raw materials and other inputs that are converted and exported outside the South African Customs Union (SACU) or BNLS customs area (comprising Botswana, Namibia, Lesotho and South Africa). There are separate preferential trade tax regimes for these latter customs areas. Other trade agreements incorporating preferential tariff regimes have been entered with Zimbabwe and Malawi.
- The exporter files the claims on a special form to the customs office, attaching statements attesting importation/conversion of inputs and subsequent marketing of the output. If satisfied, the customs office will authorize the refund.
- This facility is generally available to registered taxpayers but they need not be manufacturing for exports only. Indeed, warehousing is widely used by manufacturers to defer the payment of huge taxes on excisable goods. Until the goods are removed from the warehouse, no tax is due.
- The General Export Incentive Scheme (GEIS) is cash expenditure rather than tax incentive scheme that operated between 1990 and December 1997 when they were phased out because it contravened GATT/WTO regulations. It benefited direct and indirect exporters who must be registered with the Department of Trade and Industry (DTI). The DTI was responsible for authorizing all such incentives. The cash incentive – which is subject to taxation – was paid in accordance with a pre-determined formula.
- There is an Export Credit Insurance Scheme that is an insurance scheme operated by the Credit Guarantee Insurance Corporation Limited. The scheme is administered on behalf of the DTI to indemnify exporters against loss resulting from failure to receive payments for goods sold overseas.

- The establishment of EPZs has been accepted in principle and is being given serious consideration.

## **Latin America**

### **(A) Mexico**

- There are basically two kinds of export promotion programs in Mexico. The distinction lies in the permanency of imported goods. If imported goods are permanent in nature, goods are subject to customs duty at the time of importation. When imported goods are re-exported in the same form or used in the production of exported goods, the amount of duty paid can be claimed back as refunds. This is called duty drawback. The second kind of imported goods are those that are imported temporarily, in the sense that the goods are transformed into final products and exported. These imported goods are entitled to be free of import duty, VAT and other taxes at the time of importation since they are temporarily imported and will be exported later under specific programs. The programs facilitate such export promotion include Maquiladoras and PITEEX.

#### *Duty Drawback*

- The drawback program has been designed as an instrument of export promotion. The program provides exporters with a mechanism of refund for import duties paid on the import of raw materials, parts and components, packing and packages, fuels, lubricants and other materials incorporated into the exported products. The program also includes imported goods that are re-exported without any change in form of the goods. The program is basically provided to importers who did not know at the time of importation whether the goods would be exported later.
- Unincorporated or incorporated businesses can apply for a beneficiary of the program so long as the firms are established in Mexico.
- The exporter should transform the imported goods and export the final products within 12 months from the date of importation. He has to present his request for refunds on import duties paid to the Ministry of Commerce (SECOFI) within 90 working days from the time of exportation.
- The beneficiary can be the direct or indirect exporter. The direct exporter is required to present a copy of the export request. The indirect exporter is not importer or exporter of the goods; rather he can be manufacturer between importer and exporter. He is required to present a Certificate of Export issued to the holders of PITEEX, Maquiladora, or a company of the foreign trade program (ECEX), a letter of consent in common endorsement among parties, and a copy of the export request.

- This program was established in 1985, changed in 1987, and recently reformed in 1995. In the recent reform in 1999, the government introduced a system named Customs Bank Accounts. While requesting for refunds the direct or indirect exporters are required to deposit the amount of taxes in banks and the Customs Authority will authorize the check and refunds with interest included upon satisfaction of all required documents. Prior to this reform, insurance companies used to handle the refunds without rigorous crosscheck of documents.
- The duty drawback program is not as important as other export promotion programs explained below.

### *Maquiladoras*

- Maquiladora is the most important tax incentive program in Mexico. The program was established in 1965. At present, there are approximately 4,300 firms participating in this program. According to the Director of Maquiladoras Program, the number of firms applying for the program has been increasing rapidly from 12 firms per month in 1990 to 45 firms per month in 1999. Although the number of firms may be less than the PITEX, the amount of export sales is much greater. As of 1999, the share of its exports accounted for 40% of the total exports in Mexico.
- The program was initially set up for foreign investors and all the firms were located in special border zone with the U.S. The firms were 100% capital owned by foreigners in beginning. For example, there were only 12 foreign firms established under the program in 1965. The Maquiladoras firms were gradually modified and they are today no longer restricted to the border zone and are scattered throughout the country. This change especially took place in 1994 under the reform of the Foreign Investment Law. A part of the reason for this reform was to ensure consistency and the same spirit of NAFTA signed in 1994.
- Firms participating in the program have to be approved by SECOFI, which designed the program. Once approved, the firms can import material, fuel, package and machinery and equipment without paying import duty, VAT and other taxes. Although the holders of the Maquiladoras program are largely export-oriented, they are allowed to sell their products in the domestic market, but the amounts are subject to the following percentages of the value of the total export sales in the past 12 months. These percentages are:
  - up to 70% in 1997,
  - up to 75% in 1998
  - up to 80% in 1999,
  - up to 85% in 2000, and
  - no restriction as of 2001.
- The program does not allow newly established firms to sell goods in domestic markets in the first year since they do not have export records in the previous year.

- By law, the firm has to transform imported raw materials, gas, packages and packing into products and export those products within 18 months from the time of importation. For machinery or equipment, the firm is allowed five years from the time of importation. Failure to do so causes the imported goods to become subject to import duty and VAT. The machinery and equipment can be either returned abroad or subject to taxes, where the amount of taxes is calculated based on the import value and indexed for inflation but net of depreciation.
- Since the imported goods or the goods being transformed into final products can be sold in domestic markets, the portion of those imported materials destined to the domestic markets become liable to customs duty. There is no formula or fixed coefficients to be used to calculate this taxable portion. It is entirely based on the information provided by taxpayers.
- The holder of the Program is required to submit the annual report of total operations of foreign trade accomplished under the Program by the last working day of May. According to government officials, this report is the only piece of information to monitor the participants in the program.
- The most important sectors for the Maquiladoras firms today are the electronics industry, followed by the textile and automobile industries. The electronics and automobile firms are mainly foreign capital while the textile firms are dominantly by domestic capital.

#### *PITEX*

- Unlike the Maquiladoras program, the PITEX program provides an instrument of export promotion to domestic firms. These firms, however, can also be firms financed by foreign capital. The program offers the holder of the program duty free on imported goods and exemption of VAT provided the imports are transformed and destined for foreign markets.
- The imported goods that can be tax free are grouped into five categories:
  - raw materials, parts and components;
  - packages, packing, containers and boxes of trailers;
  - fuels, lubricants, auxiliary materials, spare parts and equipment;
  - machinery, equipment, instruments, molds and lasting toolbox;
  - apparatus, investigation equipment and accessories, communication, computer science.
- Virtually any firm can apply for either of the following two types of the PITEX program. To become a beneficiary, however, the holder of the Program must meet the following respective requirements:

- If a firm has been approved for the type of the PITEX program in which either 10% of the annual total sales or an export value of US\$500,000 per annum are exported, the firm must meet this export criterion within a year. It will then continue to be eligible for tax-free for the first three categories mentioned above.

- If a firm has been approved for the type of the PITEX program in which 30% of the annual total sales are exported, the firm must meet this export criterion within two years. It can then continue to receive tax-free benefit.

- If firms fail to meet the requirements for export criterion, their status for the PITEX program will be cancelled and their imports will be subject to customs duty and VAT. In the case of the second type of PITEX -- with no less than 30% of the total sales as exports -- the firm has to return the machinery and equipment to the exporting country or face the imposition of taxes.
- The most important sectors for the PITEX program are steel, textile, chemical and agricultural products.
- The holders of the PITEX program are required to submit an annual report of foreign trade operations undertaken within the previous year by the last working day of April. Like Maquiladoras program, this is only information for government to monitor their operations and the amount of taxes being properly paid.

#### *ALTEX*

- The program of ALTEX refers to the High Volume Exporting Companies Program. The program started in May 1990. It provides administrative and tax benefits to highly exporter companies. These companies must have exports equivalent to US\$2 million per year or 40% of their total annual sales.
- The ALTEX program offers the holders of the program the following three benefits:
  - Input tax credits under VAT are refunded in 10 working days;
  - Free access to the Commercial Information System administered by SECOFI;
  - Exemption of the requirement for the 2<sup>nd</sup> tier inspection;
  - Right to name a special customs broker – e.g., one's own employee.
- The holders of the ALTEX program are required to submit an annual report of foreign trade operation.

#### *ECEX*

- The program of ECEX provided an instrument of export promotion to Foreign Trade Companies (Programa de Empresas de Comercio Exterior). The qualified



companies must have annual export sales of more than US\$3 million and have to be approved by SECOFI.

- The holders of the ECEX program do not pay VAT on goods while making local business purchases of materials and supplies integrated into the exported products. As a result, local suppliers are making zero-rate sales to these companies. For ECEX companies, there is a cash flow advantage in input taxes under the VAT. However, for VAT a chain of the invoice credit tax system is broken and thereby increasing some administrative cost for governments.

**(B) Uruguay**

*Temporary Admission and Duty Drawback*

- Uruguay has both Temporary Admission and Duty Drawback regimes but these programs are constrained by the Mercosur Treaty. If the destination of the export is a Mercosur member country, the Temporary Admission regime can be applied under the condition that the value of its inputs is less than 40% of the f.o.b. value of the final output.
- When importing inputs from third countries other than the Mercosur region using the Temporary Admission and then exporting the final product to a Mercosur member country, one has to pay the import duty corresponding for the full value of the output on the destination country. On the other hand, if the firm exports the output to a Mercosur member country, one pays no tariff as it is considered a transaction between two members of the common market.
- There is only firm in Uruguay, the largest paper producer, uses the Duty Drawback regime.
- The Laboratory Tecnologico Uruguayo is in charge of the administration of the Temporary Admission of inputs for manufacturing exported goods. Customs is, however, entitled to proceed on classification, verification, valuation and any other examination procedure at any stage of the process.
- The budget of the Laboratory Tecnologico Uruguayo is fully funded by a 0.6% user fee on the c.i.f. value of imported inputs. The organization is responsible for the approval of the manufacturing facilities in accordance with international quality standards and the control and auditing of the Temporary Admission operations. On average, 25 users per year are fined and/or have their licenses cancelled for the Temporary Admission operations.

*Free Trade Zones*

- The first free trade zone (FTZ) was established in 1913 and it is still functioning. The other eight FTZs are privately managed and regulated by Free Zones

Directorate located in different parts of the country. The businesses established in the Free Trade Zones have the following advantages:

- Exemption for all internal taxes (but not Social Security Contributions),
  - Free capital flows,
  - No state-owned monopoly applies, and
  - Under certain conditions, goods and services in Free Trade Zones are included in the bilateral and multilateral agreements signed by the Uruguayan government.
- 
- The Free Zones Directorate is in charge of the operations in the private free trade zones. The Customs and the Tax Administration Directorate are entitled to examine free trade zone activities under specific conditions.
  - There are about 200 firms operating in the free trade zones.

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